The Budget and the Budget Process

Testimony of Richard Kogan[1]

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Mr. Chairman, Mr. Spratt, members of the Committee, I am always happy to come home to the House Budget Committee. My prepared testimony is brief. With your permission, I would like that testimony and accompanying charts, graphs, and other material to be placed in the record.

I will make four points this morning. First, the Budget Enforcement Act of 1990, which established appropriations caps and pay-as-you-go rule, is a far better budget process than some type of fixed dollar target for the deficit or surplus, such as under Gramm-Rudman-Hollings in 1986-1990 or under any version of the proposed "lockboxes."

Second, no process — not even caps and PAYGO — can force bi-partisan agreement when the principal budget players do not want to agree. Given how evenly balanced the government is between the two parties, a budget summit negotiation is probably the best budget process.

Third, the facts make it clear that excessively large tax cuts lead to serious budget problems but do little or nothing to help the long-term growth of the economy. This was true with the Reagan tax cut of 1981 and is true of the Bush tax cut of 2001. One useful budget process reform would be to require that the reconciliation process be used only if some large portion of a reconciliation bill (such as three-fourths) consist of spending reductions and tax increases. No more than one-fourth of the budgetary effects could be tax cuts or entitlement increases, so the bill in net could only be used to protect the public fisc, not dissipate it.

Finally, the Congress has yet to sort out how to deal with surpluses, especially since budget projections are just educated guesses. The simplest approach may be to develop a new consensus: agree to treat some share of projected surpluses as non-existent. At a minimum, we should be sure surpluses are real before we dispose of them. Better, we should try to preserve a noticeable share of any future surpluses to pay down the debt; that is the most direct and effective way to prepare for the inevitable cost of the baby boomers' retirement.

I will illustrate each of these points by referring to graphs or charts that I have prepared.

GRH vs BEA

GRH set fixed deficit targets declining to zero. Through excessive gimmickry and the because the economy is far stronger than the budget, the targets were missed by amounts that

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became embarrassingly huge. See slide 1.

The BEA, in contrast, was used to enforce a budget agreement made between a Republican President and a Democratic Congress, an agreement that all the leadership (except for the new wave of House Republicans) was committed to enforcing. The BEA gave the president and the leadership special tools to prevent backsliding. The BEA was extended twice and was closely adhered to until 1998, when surpluses first appeared and threw everybody for a loop. Slide 2 shows that budget outcomes were far better under the BEA than under GRH.

I would also call to your attention to CBO's 1993 annual report. CBO devoted an entire chapter to a discussion of the budget process, focusing on the lessons learned over the prior seven years. It concluded, as I have, that fixed dollar targets such as in GRH are a mistake. I have included that chapter as an attachment to my testimony. I can do nothing better than to quote CBO's conclusion:

> The past indicates that efforts to reduce the deficit are most likely to be successful if the President and the Congress first agree on policy actions and then set up processes to enforce them: deficit reduction does not work well if the process changes precede the policy actions. ... Procedures are important, but they should not be asked to do what they cannot.

If you are dissatisfied with the current state of the budget — if you are disconcerted by the fact that the President's budget calls for deficits outside of Social Security in *every* one of the next ten year — then CBO's conclusions suggest that a budget summit is the best budget process, with new caps and a new PAYGO rule, or some equivalent rules of accountability, to enforce the summit agreement after it is reached.

Tax Cuts Are The Primary Culprit

I turn now to last year's tax cut. On its surface, this would seem to be an issue of policy, not process. But issues relating to the tax cut have a bearing on process precisely because many people, possibly including some on this Committee, mistakenly believe that controlling spending through a more rigid budget process is the boulevard to fiscal responsibility. That belief misses the key point — excessive tax cuts got the nation's finances in trouble in 1981 and may also have done so in 2001. History suggests that budget process is more likely to produce sustained debt reduction if it is geared to stopping tax cuts than if it ignore tax cuts. That is why I would like to turn your attention to the historical record.

Slide 3 makes clear that last year's tax cut is far more significant than the spending increases enacted last year in causing projected surpluses to melt away. Focusing just on legislation, we see that more than three-fourths of the shrinkage in the 10-year surplus was caused by the tax cut.

There were at least four appealing arguments made for last year's tax cut.

1. Surpluses were so large that we could pay off the entire debt in a decade even with the tax cut.

2. If we didn't get rid of the surplus through a tax cut, "they" would just spend it. (Who are "they?")

3. The tax cut would promote long-term economic growth by encouraging "supply-side" decisions, such as to work more hours and to save more of one's paycheck.

4. Americans were over-taxed.

Each of these arguments was and is false. First, it is evident from this year's budget that promises of debt reduction were a mirage.

Second, the notion that tax increases lead to spending increases is contradicted by a mass of evidence. Slide 4 shows the path of spending and revenues since 1976, when the Congressional Budget Act first went into effect and the first congressional budget was agreed to. In only three of the years since then have there been both tax increases and spending increases in the same year. Far more often than not, spending goes up when revenues go down, and vice versa.

To a small extent, the data reflect not congressional policy but the economy. When the economy is in a recession, for instance, GDP is abnormally small but revenues fall even faster. Meanwhile, spending rises slightly if only because of unemployment benefits; primarily, though, spending grows as a percent of GDP because GDP shrinks, not because spending grows. To correct for the effects of the economy, slide 5 shows the data after CBO has adjusted it to remove the effects of the business cycle. Slide 5 shows what spending and revenues as a percent of GDP would have been if the economy had always been running at full employment — no busts and no booms. As you can see, the story is the same, though not quite as extreme; when revenues go up, spending goes down, not up. The two notable exceptions are right after the huge 1981 tax cut, which was accompanied by major increases in defense funding, and right after the huge 2001 tax cut, also accompanied by major increases in defense funding.

Slide 6 shows this inverse relationship between revenues and spending even more clearly. From 1983 through 2003,[2] there was a very strong negative correlation between revenues and expenditures (it is a "negative" correlation because spending goes *down* when revenues rise). Statisticians would tell you that the correlation is extremely statistically significant.[3] In short, Congress has spent most of the last twenty years demonstrating that

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[2] Data for 2003 represent CBO's reestimate of the President's budget, including the supplemental appropriations requested March 21st, adjusted for the business cycle.

[3] The "t value" for these data is more than 7 and the "r squared" is almost 75%.

conventional wisdom is wrong: in at least two cases, tax cutters were also big spenders, and in more normal times, when those who care more about the nation's fisc are in control, revenues grow and spending shrinks. I would also remind you that slide 2 showed that, during the period from 1990 to 1998, when the BEA was ascendant, spending cuts were *greater* than tax increases.

The third argument for the tax cut was that low marginal tax rates promote long-term growth, especially by providing incentives to save more and work more. There are two problems with this argument.

- Big tax cuts lead to larger deficits or smaller surpluses, of course, and that reduces the stock of capital available for investment, thereby harming long-term growth. William Gale and Samara Potter of the Brookings Institution recently concluded that, precisely because of its budgetary effect, last year's tax cut is more likely to harm long-term growth than help it.

- While some people may choose to work more hours or save more of their salary in response to lower marginal rates, others choose just the opposite. Because their take-home pay goes up, they can afford to work fewer hours; because their savings accounts grow faster, they can afford to save a smaller share of their paychecks and still meet their savings targets. This is why supply-side effects are so weak.

<u>Slide 7</u> illustrates this point by comparing rates of real economic growth during each period since 1960. It can be seen that average growth rate in the 1980s, when the top marginal tax rate was twice reduced very substantially, are the same as growth rate in the 1990s, when the top marginal tax rate was substantially increased. What is more, the 1990s achieved the same growth rates as the 1980s even though the size of the working-age population was growing more slowly during the 1990s. The conclusion must be that productivity was growing faster in the 1990s than in the 1980s, labor force participation rates were rising faster, or the number of hours worked was rising faster. These facts must be disconcerting to supply-siders since lower marginal rates, not higher rates, are supposed to produce these effects.[4]

The question of whether the nation is over-taxed is a judgment call, not subject to scientific measurement. But I call your attention to <u>slide 8</u>, which shows some facts that may

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[4] This slide also shows data on "potential" economic growth, which is CBO's estimate of the growth that would have occurred (or will occur) if the economy always operates at "full" capacity, i.e. with no booms or busts. CBO takes into account many factors, including the tax system and the condition of the federal budget. The figures reveal that CBO believes potential growth in the 1980s, when marginal tax rates at the top of the income scale were lower, and in the 1990s, when tax rates at the top were higher, were very much the same. This analysis reinforces the conclusion that large supply-side tax cuts do not by themselves improve the rate of long-term economic growth.

inform one's judgment about the levels of taxation of middle-income families and of the very well off.

The Conundrum of Surpluses

Congress has demonstrated it does not know how to deal with surpluses. Lockbox legislation tried to define the surpluses out of existence. The cause was good — since current surpluses can help us pay for the inevitable costs of the baby boomers when they retire, pretending that part of the surplus "doesn't count" (and relying on the natural public instinct to object to deficits in normal times) would lead to the salutary effect of paying off the debt and, if we are lucky, building up some reserves. But lockbox proposals are just GRH-light with a different target, and so cannot form the basis for a meaningful budget process.

Better than defining away the surpluses might be to adopt a rule first proposed by Robert Reischauer more than one year ago. He suggested that budget plans account for the reality that projections are uncertain — and for the fact that the degree of uncertainty grows as one looks farther ahead — by putting an increasing faction of any projected surplus off the table. He posited a rule under which 20% of the surplus for the next two years would be off limits, 40% of the surplus in the following two years, and so on. This would have provided a widening margin against over-optimistic projections or unforseen events. If Congress had adopted that approach last year, the tax cut would have been smaller, especially in the outyears, and the Treasury and the budget would today be better off. If surpluses keep growing *in reality*, as they grew in last year's projections, successive Congresses could adhere to the rule and still pass successive tax cuts.

Conclusion

My general conclusion is to recognize, in designing any budget proces, that large tax cuts are problems, not solutions, and therefore to design budget processes accordingly.

Specifically, I recommend a budget summit, backed up by caps and a PAYGO rule (or the equivalent as enforcement tool) if a bipartisan agreement is reached.

Second, I recommend returning reconciliation to its original intention, as a procedure to reduce deficits or increase surpluses.

Third, I recommend a formal or informal but public agreement to the Reischauer plan, under which projected surpluses would be taken with ever-growing grains of salt, and not dissipated before they materialized.